A Retirement Income Strategy for Canada

Dependence or Self-reliance:

Which way for Canada's Retirement Income System?

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ACPM

The Association of Canadian Pension Management

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SECTION I FOREWORD

Canada's retirement income system is at a critical juncture as it enters the 21st century.

The combined forces of the retirement of the Boomer Generation, rising life expectancies, and falling birth rates will seriously strain, and could possibly rupture our retirement and healthcare systems in the next 30 years. If we do not change the current rules of the game, the workforce of 2030 will face a significantly higher level of taxation than today's to support the financial requirements of these systems at that time. Most of us would agree that this is not a burden, which we should knowingly place on our children. However, we cannot wait 30 years to avert such an outcome. To do that, we must act now.

The recently completed round of CPP/QPP reforms shows that Canadians can act responsibly, well before the three cited demographic forces would have overwhelmed this modest Pillar #2 of our retirement income system. However, the CPP/QPP reforms must be seen as only a first step in the much more fundamental redesign of the overall system, which still lies ahead of us. To this end, the ACPM envisions the process for fundamental redesign involving four phases: (1) raising the awareness of Canadians as to why and how demographic forces will seriously strain, if not rupture, our retirement income system unless we take steps now to prevent it, (2) debating what those steps might be, (3) forming a consensus around the preferred change strategy, and (4) implementing that strategy.

The primary goal of this paper is to facilitate the start of redesign phases 1 and 2: raising awareness of the challenges which lie ahead, and laying out what actions we could take to make our retirement income system both fairer and more sustainable as it enters an extended period of demographic turbulence. The heart of the matter is that ACPM believes that Canadians, once they understand what lies ahead, will choose to move their retirement system in a direction which is based on an understanding that all who are able, must pay their own way. In other words, Canadians would move their system in the direction of less dependence, and more self-reliance.

To that end, Canadians have already accumulated a collective retirement savings nest egg approaching $1 trillion. This nest egg will continue to grow materially for at least another decade, especially if we take steps now to bolster self-reliance rather dependence as the foundation of the system. Clearly, it is critical that we manage these assets wisely. An important strategy to ensure this is the broad adoption of 'best practice' fiduciary governance processes which foster effective fund management in both the pension and investment fund sectors.

Meanwhile, there are some immediate steps Canadians can take to improve their retirement income system. The next Budget should begin the long-delayed process of raising the contribution limits to pension plans and RRSPs and completely eliminating the 20% Foreign Property Rule. Pension and investment fund regulation must be streamlined to increase efficiency and reduce costs. The investment industry can begin to adopt 'best practice' governance disciplines now.

SECTION II WHY THIS NEW ACPM INITIATIVE?

The Association of Canadian Pension Management ("ACPM") is the national voice of corporate and public sector pension plan sponsors in Canada, as well as of the professional firms they retain. ACPM's 1,000 members represent over 500 pension plans with aggregate pension assets of $400 billion, representing 80% of total Canadian pension fund assets.

ACPM's mission is to contribute to the growth and health of Canada's retirement income system. In the Spring of 1997, the Association commissioned a policy paper to assess the current health of the system. The Paper, titled "A Retirement Income Strategy for Canada: Creating the Best Retirement Income System in the World", observed that Canada did not have a comprehensive framework for carrying out such a 'current health' assessment. After constructing an evaluative framework, the Paper noted a number of serious deficiencies in Canada's retirement income system. Each of these deficiencies was analyzed, and 'better ways' to improve the system were recommended.

After the Paper was completed in the Fall of 1997, it was widely distributed. The Paper received favourable comment from a broad cross section of its readership, and was frequently cited in the media, and referenced in articles, other studies, and books over the course of the last two years. The Paper's authors were invited to confer with the federal, and a number of provincial governments on the Paper's recommendations.

This New 2000 Paper

While the feedback on the 1997 Paper was positive, the simple reality is that, two years later, the major Canadian retirement income system deficiencies identified two years ago largely remain, and the recommended 'better ways' lie largely unimplemented. This should not surprise any of us. Major retirement system changes do not occur without broad consensus that such changes are for the better. Achieving such consensus takes time.

Canada, like most other developed economies, has a demographic cooking in its future. Unless we begin to institute changes soon, the ratio of working taxpayers to non-working pensioners will halve from 4:1 now to 2:1 by 2030. The tax consequences of such a shift would be traumatic as these additional pensioners seriously strain Canada's financial and medical safety nets.

The purpose of this new Paper is to convince Canadians and their governments to begin to make the necessary retirement system changes now, so that our children can cope with the dramatic demographic changes which will be a certain part of our collective future in the 21st century.

How This Paper Was Written

As with the 1997 paper, this paper was commissioned by the ACPM's Advocacy and Government Relations Committee ("AGR Committee"), made up of 21 professionals across

Canada. Members have broad and varied expertise in retirement finance and economics, investments, law, and actuarial science. A Task Force made up of Keith Ambachtsheer, Martin Brown, Karen Figueiredo, Wendy Gauthier, Malcolm Hamilton, Ian Markham, and chaired by Gretchen Van Riesen, was responsible for producing the Paper. Keith Ambachtsheer wrote the first and subsequent drafts of the Paper.

A first draft of this paper was completed in August and reviewed by the AGR Committee, the ACPM's Board of Directors, and a number of respected industry participants. A second draft was shared with the attendees of the ACPM's 1999 Annual Conference for their comments and review. This final Paper benefited greatly from these review processes.

As with all ACPM papers and submissions, the members of the Task Force were not compensated for their time. The ACPM wishes to thank each of the members of the Task Force for making this important contribution to an informed discussion on a subject of such critical importance to the future financial well-being of Canadians. In addition, the ACPM acknowledges the assistance of various groups and organizations who have provided financial support to permit this paper to be printed and distributed.

Goals Of This Paper

The goals of this paper are to provide an updated assessment of (a) the key attributes of an 'ideal' national retirement income system, (b) the deficiencies of Canada's current system, and (c) to suggest steps or options to overcome these deficiencies, and to move us closer to a system which will sustain us in the 21st century. The ACPM welcomes your comments and reactions to this paper. Together, we can still create the best retirement income system in the world!

SECTION III OVERVIEW AND RECOMMENDATIONS

Paper Overview

- Two years ago, the ACPM published its policy paper "A Retirement Income Strategy For Canada". The paper observed that Canada has a retirement income system balanced by the three pillars of OAS/GIS (Pillar #1), CPP/QPP (Pillar #2), and voluntary registered pension plans/RRSPs (Pillar #3). However, the 1997 Paper predicted that, unless all three pillars were renovated in a consistent, comprehensive manner, our retirement income system would become increasingly unbalanced and unsustainable over the next 30 years. The 1997 Paper made a number of recommendations addressed to Canadian legislators, regulators, employers, and financial services providers. The purpose of the recommendations was to not only make our retirement income system more sustainable, but fairer, more transparent, and more efficient as well.

- This new 2000 Paper commences by evaluating what progress has been made over the last two years, judged by the standards we set in 1997. We note that progress has indeed been made on some fronts. An important dimension of this progress are indications that Canadians increasingly understand that, ultimately, they must tend to their own 'financial wellness' not only today, but in the future as well. They must emphasize self-reliance over dependence.

- This understanding is prompting Canadians to ask critical questions: "How much should I rely on government transfer payments to finance my retirement years?" "Where does the CPP/QPP fit in?" "What should I reasonably expect from my employer?" "What should I be doing myself?" "Where should I be looking for help with answering these questions? Through a variety of sources, they are beginning to get better answers.

- To date, these sources have not included the Federal Government, which has yet to publish its long-promised 'aging paper'. We believe this is because it is unable to come to grips with the inconsistent and conflicting goals implicit in some of the 'rules of the game' of today's retirement income system. These rules include relatively high minimum income guarantees for seniors, serious disincentives for lower and middle income Canadians to provide for their own retirement, and formidable tax barriers which make it unnecessarily difficult for higher income Canadians to maintain comparable living standards after retirement.

- Our current retirement income and healthcare systems could become unstuck as the workers-to-pensioners ratio falls from 4:1 to 2:1 over the next 30 years, requiring the extraction of a significantly higher level of tax revenues out of the 2030 workforce, unless we begin to change the rules of the game now. It is cold comfort that most of the developed world faces the same, or even worse grim prospects.

- Meanwhile, the $1 trillion retirement savings pool Canadians have already accumulated, and which will continue to grow steadily during the next decade, will not produce the largest

possible retirement ‘nest eggs’ down the road as it is currently being regulated and managed. The still-inefficient regimes regulating pension plans and investment funds (eg., mutual funds, segregated funds, etc.) create unnecessary financial burdens on plan sponsors and participants alike, and is a material impediment to pension plan and RRSP creation and participation.

- Meanwhile, the still-too-high costs of investing retirement savings will severely curtail the ability of Canadians to produce adequate pensions down the road. This inefficiency stems from the weak governance processes of many Canadian pension funds, and from their virtual absence in Canadian investment funds. Yet a third problem is the continued insistence by the Federal Government to restrict investing retirement savings outside Canada through the Foreign Property Rule (FPR). The FPR is negatively impacting the return and the risk of the retirement savings of Canadians, and at the same time increasing their costs. Ironically, the FRP benefits no one.

- In short, we do not believe that the current retirement system ‘rules of the game’ as defined by the Income Tax Act, by regulatory practices, by governance practices, and by the financial services industry are sustainable. The current system will provide too little retirement income at a too high cost in an unfair manner 20 to 30 years hence.

- The long time-frame needed to intelligently assess these retirement income system issues is problematic. It lies well outside the bounds of the standard four year political cycle. Thus the leadership for change will have to come from ordinary Canadians, their employers, and where relevant, their unions or employee associations. This will not happen without a broad understanding of the issues and their consequences. An important goal of this paper is to help foster that understanding.

Summary Of The Recommendations

This new Paper organizes the steps which must be taken into ‘to do’ lists for the people who must take them. These steps are detailed in Section VI, and summarized here:

- Canadians ‘at large’ must take charge of creating their own ‘financial wellness’ plan. Where Canada’s current social policy and tax arrangements are at odds with implementing the plan, they must be prepared to take their concerns to their employer, their financial services provider, their provincial MPP/MLA, or their federal MP, depending on the nature of the concern. They must make their voices heard.

- Pillar #3 (i.e., the voluntary component of the system) must be strengthened now. The current financial disincentives (i.e., very high tax/clawback rates on retirement income) should be addressed by setting a 50% ceiling on combined tax/clawback rates. At the same time, tax-deferred contribution room into voluntary pension plans or RRSPs should be doubled. An important benefit of this strategy would be to shift a portion of income tax revenues from now (a period of fiscal surplus), into the future (when demographic forces will return us to fiscal deficits).

- Canadian employers, unions, employee associations must use their informational and knowledge advantage to further the ‘financial wellness’ interests of their workforce or members. For example, they should insist on simple, efficient, uniform Canadian regulatory regimes for pensions and investments. They should ensure the pension plans they administer are effectively governed and managed.

- Effective leadership by the Federal Government would make a huge difference. It should acknowledge that the accumulated national debt is a major problem, and that the CPP/QPP (ie., Pillar #2) reform steps already taken only begin to address the major economic and moral challenges Canadians will face as our workers-to-pensioners ratio begins to fall significantly, starting in less than a decade from now. It should play a leading role in sketching out the implications, and create processes through which Canadians can come to grips with the difficult choices they face.

- We believe that through such processes Canadians would come to clearly understand that public debt reduction should be a much higher priority, and that Pillar #1 (ie., tax-financed public pensions) growth must now be firmly curtailed. Taxpayers 30 years hence will have their hands full not only supporting rising public pension claims, but a heavily strained healthcare system as well.

- To defend the freezing of tax-deferred contribution limits into pension and retirement savings plans, the federal government has consistently made a ‘tax expenditures’ argument, claiming it could not afford to raise the limits for budgetary reasons. It has never produced any credible research to support this view. ACPM believes that such research would show that the ‘tax expenditures’ argument is vastly overblown, largely because it has confused tax deferral with tax forgiveness. We urge the federal government to produce a credible ‘tax expenditures’ paper related to tax-deferred pension and retirement savings contributions.

- Meanwhile, the Federal Government can do a number of things as early as the February 2000 Budget. As a first step, it should accelerate its debt reduction program. It should raise the far too low contribution limits on pension plans and RRSPs by 20%. It should scrap the Foreign Property Rule entirely. It should encourage its regulators to create a more efficient prudential/regulatory regime for pensions and investment funds.

- Provincial governments should instruct their education ministries, with the assistance of financial services industry, to design and require the teaching of ‘financial wellness’ courses at the primary and secondary school levels. They should encourage their regulators to create a more efficient prudential/regulatory regime for pensions and investment funds.

- Canada’s financial services industry can help devise effective education programs to help their clients build informed ‘financial wellness’ plans. It should offer Canadians transparent, low cost, easily accessible investment vehicles with which they can reliably meet their long term ‘financial wellness’ goals. It should take the lead in creating investment fund governance mechanisms which look after the financial interests of unitholders first.

We believe that, taken together, these measures would give Canada the best retirement income system in the world. However, time is getting short. We need to act now.

SECTION IV WHAT WE SAID IN 1997, AND WHAT HAS HAPPENED SINCE

Like a sturdy stool, the ideal retirement system has three legs. The World Bank introduced their ‘three pillar’ model in 1994 [1]. The 1997 ACPM Report used this model as its starting point:

- Pillar 1 is a tax-financed, means-tested, minimum pension provided by the state.
- Pillar 2 is an employment-based, mandatory pension plan to which everyone in the workforce must belong.
- Pillar 3 is comprised of a variety of fully funded, privately managed retirement savings or pension plans, making up a voluntary third layer of the retirement income system.

Collectively, these three pillars should support a system which balances five goals: (1) adequacy (ie., an appropriate income replacement rate), (2) fairness (ie., everyone has the opportunity to retire at an appropriate age with an appropriate income), (3) sustainability (ie., adaptable to changing demographic and economic circumstances), (4) transparency (ie., participants understand the system and their role in it), and (5) efficiency (ie., maximizes pensions paid out per dollar paid in).

How Did Canada Measure Up In 1997?

The 1997 Report noted that Canada does indeed have a three pillar system. Pillar 1 is our tax-supported OAS-GIS program, plus provincial add-ons. Pillar 2 is the partially funded mandatory CPP/QPP. Pillar 3 is a legion of fully funded voluntary pension and retirement savings plans. We can take some satisfaction from the fact our retirement income system is better balanced and more flexible than those of other developed countries such as France, Germany, Italy, and Japan. However, we should not celebrate too long or too hard. As currently placed, our three pillars will be subject to increasing stresses and strains within ten years as the boomer generation begins to retire.

The 1997 report evaluated Canada’s status in terms of the five cited retirement system goals. Some of its key conclusions were:

- The minimum income support levels embodied in our current Pillar #1 OAS-GIS program (including additional provincial benefits) are generous.
- The current system favors seniors at the expense of lower income working Canadians.
- The sustainability of the current system will come under increasing pressure as Canadian society ages considerably over the next 30 years.
- Canadians are not as retirement income-literate as they should be. Neither the public sector nor the financial services industry has been as helpful as it could be.

- Three major impediments to accumulating sufficient retirement savings at affordable contribution rates are the Foreign Property Rule, burdensome regulatory regimes, and high sales and management fees in the investment funds sector.

Proposed Pillar Renovations In The 1997 Report

In response to this listing of structural and operational shortcomings, the 1997 Paper offered a menu of possible solutions. First, the paper was concerned about the lack of cohesion among the three retirement system goals of adequacy, fairness and sustainability. It recommended a number of measures to redress that imbalance, including common standards of minimum income support for seniors and working people, combined tax/clawback rates for seniors no greater than 50%, and reasonable opportunities for higher income Canadians to maintain their standards of living after retirement.

To raise Canadians' understanding of their retirement income system and the principles of retirement finance, both public sector agencies and the financial services industry were urged to become more pro-active and more effective in their information and educational activities. To maximize the production of retirement income per dollar of contribution, the 1997 Paper recommended the removal of the foreign property investment limit, the creation of a simplified, unified pension regulatory regime, and the creation of a series of low cost, easily accessible retirement savings products by the financial services industry.

Developments Since 1997 Related To The Adequacy, Fairness, And Sustainability Goals

Since the release of the 1997 Paper, there have been a number of important developments related to the issues discussed in that Paper. First, related to the adequacy-fairness-sustainability goals, we note the following:

- Federal and provincial fiscal policies continue to reduce Canada's debt to GDP ratio, slowly improving governments' ability to cope with the serious fiscal pressures arising from demographic pressures starting in less than a decade, and growing stronger in successive decades.

- The Seniors Benefit proposal which would have continued to guarantee seniors a tax-free income well in excess of what working people are allowed to earn before being subjected to income tax, and which would have worsened savings incentives even more, has been dropped.

- Recent Federal Budgets have begun to raise the basic personal and married tax credits in the Income Tax Act. However, Canada's social policies continue to treat retired seniors considerably better than working people.

- Spurred by the path-breaking research of Christopher Sarlo of the Fraser Institute, it has now become acceptable to differentiate between true poverty lines in Canada and the higher "Low Income Cutoff" measures traditionally published by Statistics Canada. The new Market Basket Poverty Measures now being calculated by the federal government promise to be better assessment tools for testing the adequacy and fairness of social policies [2].

- The CPP Investment Board is now operational, and is beginning to invest surplus CPP funds in the financial markets under the same rules governing other pension funds. Parliament has just passed legislation to establish a Public Service Pension Investment Board to invest the assets of the federal civil service, military, and RCMP pension plans in a similar arms-length manner. This legislation also reforms the rules regarding the funding of these plans, bringing them in closer alignment with private sector requirements.

- The introduction of the Pension Adjustment Reversal (PAR) in the Income Tax Act restores some of the RRSP contribution room foregone by members of defined benefit pension plans when they terminate the plan. Canadian pension regulators have endorsed flexible pension plans which permit plan members to tax-effectively improve their own benefits and certain provinces have enacted legislation to address these designs.

- Serious research is now under way into the true magnitude of the "tax expenditures" associated with the granting of tax deferrals to registered pension plan and RRSP participants. We expect that this research will show that when realistic assumptions are made about savings behaviour in the absence of the tax deferral rules, and when it is recognized that there is a vast difference between tax forgiveness and tax deferral, true pensions-related "tax expenditures" in Canada are in fact somewhere between very modest and completely inconsequential. Such findings would contrast sharply with the unrealistic $15 billion (or even higher) annual "tax expenditure" estimate which has floated around Ottawa since the mid-1990s, but which nobody will take responsibility for as to its credibility [3].

New Developments On The Transparency Front

On the transparency front, some good things have happened in the last two years, largely in the form of thoughtful, easily accessed research and analysis published as commissioned studies, newspaper and magazine articles, and books. This is an important development. ACPM believes the process of making the still-needed major changes in Canada's retirement income system will not be led by government, but by Canadians themselves. Here is a sampling of these new 'transparency' works:

- Pete Peterson's book "GRAY DAWN: How The Coming Age Wave Will Transform America…And The World" takes a cold, hard look at the implications of global aging. He argues persuasively that the developed world is not yet prepared for its political, economic, and moral consequences. How do we prepare? We must do five things: (1) Encourage longer work lives. (2) Raise more, and more productive children. (3) Stress familial cohesion and obligations. (4) Target benefits based on need. (5) Require people to save for their own old age [4].

- These ideas are echoed in Dian Cohen's book "THE NEW RETIREMENT : Financial Strategies For Life After Work". She says that we need to rethink both work and retirement in the new world we now live in. The traditional ideas of long service careers until age 65 with a single employer, and rock-solid universal financial and medical safety nets after that, need to be discarded. Instead, Canadians should focus on building their own life plans and plan to fund their retirements with their own lifetime retirement savings [5].

- The C.D. Howe Institute has been especially active in publishing research on pensions and retirement income issues in recent years. Since 1997, it has published three papers on CPP reform, two on the CPP Investment Board, one on flexible retirement, one on the Seniors Benefit proposal, one on intergenerational transfers, and one on Federal Government policy towards retirement income generally [6].

- Books by Keith Ambachtsheer and Don Ezra ("PENSION FUND EXCELLENCE: Creating Value For Stakeholders") and Mary DiSpalatro ("THE NEW IMPERATIVE: The Plan Sponsor's Guide To Successful Employee Communication And Education") offer guidance to employees and pension plan fiduciaries on how to best discharge their responsibilities [7].

- Through her 1995 and 1998 studies of the Canadian investment funds industry, Glorianne Stromberg has raised fundamental questions about the current relationships between the ability of Canadians to achieve their 'financial wellness' goals, our education system, the structure of the investment funds industry, and the legislative/regulatory umbrella which supposedly levels the playing field for investment fund investors. She argues persuasively that the current playing field is in fact not level, and that we need to make fundamental changes in how we teach the paths to 'financial wellness' in our schools, in how the mutual fund industry is structured, and in how it is regulated [8].

New Developments Related To Improving System Efficiency

Finally, there is the efficiency goal for our retirement income system. As with the transparency goal, the noteworthy developments here over the last two years have been more in the form of good words than concrete actions:

- The Senate Committee on Banking, Trade, and Commerce chaired by Senator Michael Kirby held hearings on the governance practices of Canadian pension and investment funds. In its resulting report "THE GOVERNANCE PRACTICES OF INSTITUTIONAL INVESTORS", the Committee recommended strengthening the governance practices of pension funds, and especially of investment funds [9]. Glorianne Stromberg reached the same conclusions in her studies.

- A research study by Keith Ambachtsheer, Ronald Capelle, and Tom Scheibelhut ("IMPROVING PENSION FUND PERFORMANCE") found a statistically significant relationship between the organizational performance of pension funds and the quality of their governance and management processes [10].

- The Canadian Securities Administrators (CSA) issued a concept paper “A FRAMEWORK FOR MARKET REGULATION IN CANADA” in February of this year. It advocates dropping the old fragmented, institution-based structure of regulation, and moving to a functional model. This means adopting similar regulations for similar products/services, regardless of who the provider is. Regulations will have either a prudential (i.e., solvency) or market (i.e., consumer protection) focus. The CSA expresses the view that all market-oriented regulation should be carried out at the provincial level, using a “co-ordinated, harmonized regulatory structure across the country” [11]. The Ontario Securities Commission also issued a “STATEMENT OF PRIORITIES” for the coming 12 months in June of this year. Examining investment fund governance and regulation figures prominently in this document. The OSC has commissioned lawyer Stephen Erlichman to study this issue. His paper is due by year-end 1999.

- The list of organizations and people advocating the lifting of the 20% Foreign Property Rule continues to grow. The Senate Committee on Banking, Trade, and Commerce and the House of Commons Finance Committee have both voted to do so. New studies on the ongoing harm the 20% FPR is causing Canadians have recently been released by the Fraser Institute and the CD Howe Institute [12].

In addition to these good words, there have also been some concrete actions to improve retirement system efficiency, with ACPM an active participant in two initiatives:

- The ACPM, together with the Federal Office of the Superintendent of Financial Institutions (OSFI), the Financial Services Commission of Ontario (FSCO), and the Pension Investment Association of Canada (PIAC) are developing a single set of pension fund governance principles, as well as a governance effectiveness self-assessment tool for pension fund fiduciaries. This initiative followed directly from the Senate Committee’s recommendations related to governance practices cited above, and from OSFI’s prior initiative to move pension system oversight away from detailed rules towards prudential oversight and broad guidelines.

- The ACPM, through a Task Force chaired by Priscilla Healy, has developed a single Uniform Pensions Act for Canada. The goal is to replace the quilt patch work of the various federal and provincial laws governing pensions now, with a single set of rules which would govern all Canadian pension plans. If this goal were achieved, Canadian pension plan sponsors with employees in more than one jurisdiction would reap significant efficiency gains, and lower administrative costs. A draft Act has been circulated to stakeholders, and consultations are under way. Unfortunately, even as these consultations are under way, a number of provinces continue the practice of changing their own legislation without duly assessing its impact on the goal of national uniformity.

- While the market-regulating CSA is talking about re-organizing, some prudential regulators have already done it. For example, the new Financial Services Commission of Ontario (FSCO) became operational July, 1998. It regulates pension plans, insurance companies, trust and loan companies, credit unions, and mortgage brokers registered in Ontario. Before, these functions were carried out by separate commissions for pensions, insurance, and deposit-

taking institutions. However, FSCO's goal to achieve full co-ordination and alignment of all policies has yet to be achieved.

- Fees on some passively managed index mutual funds have halved over the last two years, coming down from about 1% per annum to 0.5% per annum. However, there is no evidence of any material reduction in fees on actively managed mutual funds, where most Management Expense Ratios (MERS) continue to exceed 2% per annum.

What Has Not Happened In the Past Two Years

The last two years produced little evidence that Canadian governments understand the urgency to update the rules governing Canada's retirement income system now, so that it can generate adequate retirement income streams for Canadians in a fair and sustainable manner through the first half of the 21st century. Yes, our regulators have acknowledged that regulation needs to be refocused and streamlined. Yes, there has been some action to remove some Income Tax Act obstructions to funding pensions. Yes, the CPP Investment Board is now operational. However, these events pale in comparison with these facts:

- No Federal Government paper on the implications of an aging society for Canadian economic and social policy has been published, nor are we aware of any task force working on such a paper. Nor has there been any notable improvement in the efforts of government departments and agencies to publish more relevant and useful information in such areas as seniors' poverty, self-directed RRSPs, group RRSPs, and pensions-related "tax expenditures".

- The absence of such a paper suggests an unwillingness or inability by the Federal Government to come to grips with the inconsistent and conflicting goals implicit in the current retirement income system 'rules of the game'. Perversely, these rules include relatively high minimum income guarantees for seniors, strong disincentives for lower and even middle income Canadians to provide for their own retirement, and formidable tax barriers making it very difficult for higher income Canadians to maintain their living standards after retirement.

- A specific example which reflects the Federal Government's apparent attitude towards fostering retirement savings is Canada's continually frozen pension plan and RRSP contribution limits, which are already about 50% below their U.S. and U.K. counterparts. Meanwhile, the Income Tax Act continues to favour public sector over private sector pension plans. For example, the 1997 ACPM recommendation to reduce the pension adjustment factor from 9 to 7 for plans providing less generous ancillary benefits (and thus providing more RRSP contribution room for these plan members who are primarily in the private sector) has yet to be addressed.

- The most extreme example of the unwillingness of the Federal Government to deal with the blockages and barriers embedded in our current retirement income system is the 20% Foreign Property Rule. Despite the ongoing financial damage caused by the FPR, and despite the

broad consensus among academics, professionals, and even politicians that this rule is harmful and serves no good purpose, it remains unchanged in the Income Tax Act.

- The most important contribution provincial governments could make to strengthening Canada's retirement income system is to require that 'financial wellness' becomes a required field of study at the primary and secondary education levels. After all, if it is good public policy to create incentives and opportunities for Canadians to secure their own retirement, they need to have at least a basic level of knowledge about what it takes to achieve lifetime 'financial wellness' as they enter the workforce. Yet, courses on personal financial management continue to be almost non-existent in our education system [13].

The paper now turns to the question of where we go from here.

SECTION V CREATING A BETTER BALANCE BETWEEN ADEQUACY, FAIRNESS, AND SUSTAINABILITY

This section of the paper addresses the 'where do we go from here?' question as it relates to the sustainability, fairness, and adequacy goals. It shows why the recent CPP/QPP reforms are only the beginning of needed broader retirement system reforms, and not the end. The section ends with a listing of possible further steps we need to take to finish the job.

The System's Achilles Heel: Sustainability

Our government is taking pride in 'fixing' the CPP/QPP in advance of the accelerating claims the soon-to-retire baby boom generation will place on these plans. However, this pride must not translate into a belief that Canada is now fully prepared for the extraordinary aging of its people in the 21st century. It is not. To fully appreciate this, consider that the ratio of Canadian workers to pensioners is projected to halve from 4:1 to 2:1 over the next 30 years. Remember that aging boomers are not the only contributors to an aging population. Rising life expectancies and falling birth rates also play major roles. Let us see what these developments mean financially [14].

Our Pillar #2, the CPP/QPP, is designed to replace a maximum of 25% of final earnings up to the average Canadian wage after retirement. So, for example, a married couple with a combined 80 year working life would be paid a combined maximum pension of about $18,000 per year today before taxes. The CPP/QPP 'fix' is to eventually pre-fund about a quarter of accrued CPP/QPP obligations, which should stabilize the contribution rate at 9.9% of pay up to the average wage, if all the assumptions work out [15].

Meanwhile, our Pillar #1, the OAS-GIS system guarantees about the same amount ($17,500) as a partial income-tested, tax-free minimum to all Canadian couples who qualify. In addition, the $5000 per person per year OAS is also paid out to higher income Canadians, subject to income-related claw-backs. These guarantees too will be seriously strained by the accelerating OAS-GIS claims the retiring baby boom generation will place on future taxpayers. Yet, this Pillar #1 reality of rising costs is nowhere reflected in Canada's financial books today, as this part of the system continues to operate on a 'pay-go' basis.

That is not all. Maintaining our medical safety net is already straining our financial resources with 4 workers per pensioner today. Barring major behavioural changes, that ratio will halve to 2 workers per pensioner 30 years hence, a time when a much larger seniors population will be placing much greater demands on the healthcare system. This medical pillar reality of rising costs is also not reflected anywhere in Canada's financial books today as it too continues to operate on a 'pay-go' basis.

What is this aging phenomenon going to cost future taxpayers? If we do not change the rules of the game, the OECD estimates Canada's public spending on pensions and healthcare would rise from 13% of GDP in 1995 to 23% in 2030. This implies an incremental cost equal to 10% of GDP by 2030 [16]. If such a shift were fully financed by taxes on future taxpayers, tax revenues

from all sources would have to rise about 30% in real terms. If this increase seems shockingly high, consider the following two facts:

- The recent 17th CPP Actuarial Report calculates today's 'pay-as-you-go' CPP contribution rate at 8% of covered earnings versus a 2030 'pay-go' rate of 11%. Thus this calculation implies a projected cost increase relative to covered earnings of 38% due to the aging phenomenon. The Actuarial Report on OAS/GIS projects a spending increase on this program from 2.5% to 3.3% of GDP in 2030, a 32% increase.

- Social policies in continental Europe have led to a situation where their workers per pensioner ratio is already in the 2:1 area today, with public spending on pensions and healthcare already in the 20% of GDP area, heading for 30%.

The point is that unless current generations of Canadians take steps to change our retirement income system now, we will be burdening future taxpayers with even significantly higher tax levels than we face today. This raises two issues. The first is fairness. Even if future taxpayers choose to pay up, is it right of us to ask them? The second issue is sustainability. What makes us think that these future taxpayers really will pay up simply because we decided today that they should?

The System Is Already Unfair Today

We have just shown that, unless we make significant changes now, Pillar #1 of Canada's retirement income system will become increasingly unsustainable and unfair as time passes. This does not mean the system is fair today. We noted that it has already become fundamentally unfair in a number of ways:

- Pillar #1 of the system today provides seniors with larger after-tax benefits than working people are allowed to earn before they are subjected to income and payroll taxes. At the same time, seniors collecting CPP/QPP pensions paid only a fraction of their true cost. All seniors benefits are fully indexed, while working people face automatic tax increases through bracket creep. In short, over-65 Canadians have already become an advantaged class, now better off financially than many of the younger working Canadians who sustain them. Where is the fairness in this?

- The system fails to reward those who work and save. For example, at the lower end of the earnings scale, a single Canadian collecting $6000 from CPP and $5000 from OAS will find that more than 70% of the first $80,000 of her or his pension savings will be lost to taxes and GIS clawbacks. This person was probably in a 25% tax bracket while contributing into the RRSP. Where is the incentive to save in these circumstances?

- Meanwhile, at the higher end of the income scale, Canadians have seen the tax deferral limits on pension contributions frozen for decades (since 1976!), now also joined by frozen RRSP limits. As a result, there are no viable retirement savings opportunities to maintain pre-retirement living standards for Canadians earning more than twice the average wage, who

pay a disproportionately large share of all taxes. We have already noted that these punitive measures have been justified because pensions-related 'tax expenditures' would otherwise be too high for the economy to sustain. No credible research has ever been presented to support this claim. Indeed, we believe credible research would show the claim to be unsupportable.

- The 1997 ACPM study explained in some detail how the pension adjustment (PA) system introduced in 1990 shortchanged the members of most private sector pension plans. The study showed how the PA system could be made fairer, creating more RRSP contribution room for private sector workers [17]. To date, no action has been taken. The 1997 study also showed how families with one pension are being disadvantaged in relation to those being able to split incomes through the use of a spousal RRSP. Again, no action on the suggested remedy has been taken.

These observations on system fairness (or lack of it), and the prior observations on system sustainability (or lack of it), lead us to another look at the question of pension adequacy.

What Is An 'Adequate' Minimum Pension?

The adequacy question raises two issues. The first relates to the minimum level of income support seniors should be entitled to in the absence of any pensions or retirement savings. The second issue is whether there is a useful 'normal' target relationship between what people earn before retirement and what they need to maintain their standard of living after retirement.

We have already noted that the combination of OAS and GIS guarantees a senior couple an after tax income of $17,500 ($10,800 for a single senior). In many provinces, this guaranteed minimum will be further supplemented by provincial assistance plans and tax credits. In Ontario, for example, the final figure exceeds $20,000. In setting these levels, governments are presumably guided by a view of the minimum income needed to live a decent life (though we have already noted that there seems to be a lower standard for working people with higher expenses, where married couples and singles start paying taxes at incomes of about $13,500 and $7,100 respectively).

Though never intended for the purpose, poverty level benchmarks have historically been based on the 'low income cutoff' (LICO) table regularly published by Statistics Canada. For example, its 1996 threshold was $18,400 for a couple without children living in an Ontario city with a population in the 100,000-500,000 range. It turns out that this LICO measure is 16% higher than the comparable, newly calculated poverty line "market basket measure" of $15,800.

A current minimum pension guarantee (federal plus provincial) of $20,000 is 27% above the market basket poverty measure. The personal no-tax income threshold for working married couples of $13,500 is 17% below it - this is even before adjusting for their higher work-related expenses and payroll taxes.

What Is An 'Adequate' Pre-Retirement Income Replacement Rate?

We now turn to the question of adequacy for Canadians with pensions and/or RRSPs. The traditional rule of thumb has been that 70% of final gross earnings is a good target income replacement rate for retirement planning purposes. Recent research by Malcolm Hamilton suggests that this historical target may be overly ambitious and misplaced, especially for heavily taxed, middle income Canadians [18].

Hamilton shows that working, middle income, "typical" Canadian parent who is raising kids, paying down mortgages, and paying Canadian-style taxes may have annual gross family incomes in the $50,000 and up area, but have actually only $20,000 to spend on personal consumption. This is no more than what a Canadian seniors couple is guaranteed today through OAS-GIS plus some additional provincial benefits, without ever having saved a penny for their retirement years.

This parity raises some interesting questions. Should "typical" Canadians try to replace 70% of their gross income after retirement if they are effectively living on only 40% of their gross incomes during their working lives? Should "typical" Canadians bother saving at all for their retirement (except maybe earlier retirement) if the public purse guarantees them almost 100% replacement of the monies they had available for consumption during their working lives?

Do the social and tax policies which produce this kind of work/post-work income parity without any need to save make any sense for Canadians as we enter the 21st century? Are we comfortable with a system which taxes earned income at rates which reduce seemingly good incomes to very modest ones, and then provides open-ended guarantees to continue these modest incomes after retirement on the backs of future taxpayers? Especially on the backs of future taxpayers who will be straining to pay for a healthcare system under siege 30 years hence? Is this not rolling the dice on a grand scale?

So, where do we go from here? Is there a better way?

Where We Should Go From Here: Understanding The Issues First

The first thing Canadians should do is to really understand the 'financial wellness' situation they find themselves in today. A major purpose of this ACPM report is to help them do that. ACPM intends for this report to receive wide distribution. We also intend to sponsor forums where its findings and ideas can be discussed and debated. We invite other concerned individuals, groups, organizations, and governments to join us.

For this discussion and debate process to be constructive and effective, all participants will need to take a broad, unbiased view of the issues. Thus, taking the lead from such writers as Pete Peterson, Dian Cohen, Glorianne Stromberg, and Malcolm Hamilton, we need to ask the really big questions:

- Is the traditional life cycle model of 'work 40 years for the same employer and retire at 65' still relevant in the 21st century? If not, what should we replace it with? What are the implications for how we redesign our retirement income system?

- How prepared or unprepared are Canadians to take better charge of their own financial futures? How do we best fill the knowledge gap? What are the respective roles of governments, the education system, employers, and financial services providers?

- What does the coming rapid aging of Canadian society imply for fostering a rising birthrate? Higher immigration rates? Greater familial responsibility for caring for the elderly? A fundamental rethinking of a healthcare system already strained today?

- How do we redesign our retirement income system so that it becomes sustainable and fair, while still offering those without their own means, an adequate, publicly funded financial safety net?

What kind of answers would an informed discussion and debate on these questions produce?

Where We Should Go From Here: Moving To A Better Adequacy, Fairness, Sustainability Balance

Given sufficient discussion and debate, we believe most Canadians would agree that their 21st century retirement income system must be able to accommodate far greater flexibility in how people plan their working and non-working lives. They would also agree that many Canadians are currently ill-equipped to design and execute their own 'financial wellness' plans which fit the new life cycle model. This leads us to conclude:

- A good retirement income system must be transparent, and people must know their own role in it. Canadians have begun to realize this, and have become increasingly insistent that their governments, their education system, their employers, and their financial services providers give them the information and the knowledge they need to design and execute their own 'financial wellness' plans. This insistence is well-placed, and should continue unabated in the years ahead.

We also believe Canadians would accept that, with the coming rapid aging of Canadian society, the underwriting by future taxpayers of lifetime universal pensions must be carefully limited. Further, they would agree it is unfair that such tax-funded pensions would be higher than levels where working people begin to be taxed to pay for these pensions. These beliefs have the following implications:

- To sustain Pillar #1 public pensions during the coming 'crunch' years, it is critical to contain its growth to the minimum rate possible. The best hope for the sustainability of Canada's public pension and healthcare systems lies in healthy GDP growth and a concerted effort to reduce the absolute size of the public debt while we still can.

- No Canadians should pay income or payroll taxes on earned income below the Market Basket Poverty Measure.

- We need to move from a system which currently provides incentives for people to retire early, to one which provides incentives for people to stay in the work force as long as they are willing and able to do productive work.

Finally, we believe that Canadians, if they understood the financial implications 20-30 years hence of today's rules, would prefer the path of self-reliance to financing their retirements over the path of entitlement and state dependence which is the orientation of much of today's retirement income system. These beliefs have the following implications:

- We already noted that the best collective route to increased self-reliance for Canadians is to aggressively reduce the size of our national debt now. For example, debt service continues to be by far the largest single federal government expenditure, consuming almost a third of the $150 billion total expenditures. We will need far greater flexibility when the financial crunch hits 20-30 years from now. This longer term view raises serious questions about the wisdom of the federal government's current '50-50' policy of allocating 50% of budget surpluses to new program expenditures, and only 50% to tax and debt reductions combined.

- Canadians would also understand the importance of building new wealth before the ratio of workers to pensioners begins to fall significantly. The initiative to partially fund the second pillar of our retirement income system (ie., CPP/QPP) can be viewed as a step in that direction. However, Pillar #2 is a relatively modest component of the total system, intended to replace a maximum of 25% of earned income up to the average wage. While ACPM has supported the outcome of the CPP/QPP reform process to date, it believes it would be a mistake to expand the CPP/QPP pillar.

- Thus if Canadians' reliance on the tax-financed Pillar #1 is to decline over time, and if Pillar #2 is to remain a relatively modest component of the total system, the only remaining tax-effective sources of higher income replacement rates are tax-deferred voluntary Pillar #3 arrangements.

- Fostering a healthier, more diverse Pillar #3 will require two fundamental changes in tax policy. First, low and middle income Canadians should not be subjected to combined tax/clawback rates in excess of 50% on retirement income. Second, the tax-deferred contribution room available to build up voluntary Pillar #3 pension arrangements should be doubled. Such a doubling would only lead to matching the pensions-related contribution room already available to Americans and the British. Rather than producing 'tax expenditures', we believe this measure would have the beneficial effect of shifting tax revenues from today (when we are generating surpluses) to tax revenues in the future (when, as we have already demonstrated, we are likely to be running deficits again).

- An additional measure would be a new individual retirement account which would be funded with after-tax money, but where the accumulation of investment income, and ultimate withdrawals upon retirement, would be tax-free. This measure could be introduced during a transition period while the tax deferred contribution room is being doubled.

The greater self-sufficiency strategy ACPM proposes would boost the flow of long term retirement savings in this country. We would be foolish if we did not also ensure that these savings are invested prudently and productively, and that they indeed lead to more secure and higher retirement incomes down the road.

The next section of this report looks at what we need to do to improve the efficiency of Canada's retirement income system.

SECTION VI INVESTING THE RETIREMENT SAVINGS OF CANADIANS PRUDENTLY AND PRODUCTIVELY

Canadians have built up a sizable retirement savings treasure trove already. Through asset returns and additional contributions, including those going to the new CPP and federal Public Sector Pensions (PSP) Investment Boards, that trove is already destined to grow considerably larger in the next decade. If we now also refocus our retirement system away from an emphasis on entitlement and dependence towards greater individual responsibility and self-sufficiency, it will grow much larger still. These realities make it critical that we invest our retirement assets prudently and productively. This section of the report examines what we need to do to ensure this actually happens.

Canada's Retirement Savings Treasure Trove

According to the latest Statistics Canada figures, the market value of registered pension plan assets stood at $500 billion at the end of 1998. Meanwhile, the market value of investment fund assets reached $350 billion. Taking two-thirds of investment fund assets to be retirement-related, the implication is that the accumulated tax-deferred retirement savings of Canadians now amount to $750 billion, or 85% of GDP. As bases of comparison, the value of the retirement savings of Canadians has caught up with (and will likely soon surpass) the total assets of Canada's chartered banks or the outstanding debt of our federal and provincial governments. No doubt, there are additional accumulations of retirement savings beyond the visible $750 billion. In total, an accumulation of $1 trillion would not seem far fetched.

Registered pension plan cashflows including investment income were $40 billion in 1998, while net flows into investment funds were $50 billion. . Taking two-thirds of that $50 billion to be retirement-related, a combined flow of $75 billion results. We noted that just the new CPP and PSP Investment Boards alone will eventually add in excess of $10 billion to this retirement savings flow. Placing a 50% ceiling on retirement income tax/clawback rates, and doubling the contribution limits on voluntary Pillar #3 retirement savings would yet again boost Canada's retirement savings flow. Adding all of these sources, an annual flow approaching $100 billion becomes a possibility within a few years.

How Will Increasing Retirement Savings Flows Impact the Canadian Economy and Financial Markets?

There is no obvious, direct relationship between increasing Canadian retirement savings flows and the course of the Canadian economy, its currency, or its financial markets. The reason is that in an open economy such as Canada's, many factors inside and outside Canada impact on our GDP growth and financial prices. Collectively, these many other factors will be more important determinants of the course of future Canadian GDP growth and financial prices than an increasing domestic retirement savings flow.

There are, however, some things we can say with reasonable certainty:

- Healthy democratic societies have a broadly-based ownership of the means of production, giving most participants a visible, direct stake in how well the economy functions. An increased retirement savings flow, which is also broadly based, facilitates this process.

- To the degree an increased retirement savings flow produces incremental wealth in the form of incremental capital formation, which leads to an increased ability to produce goods, services and taxes down the road, everyone wins. A corollary is that increased retirement savings flows during our current fiscal surplus years, naturally defer the taxes associated with these flows into the coming period of fiscal deficits associated with the boomer retirement years.

- A retirement income system which is based on claims on the earnings of the means of production (ie., public and private corporations) is more likely to be stable and predictable in the long run than a system based on income transfers through taxation. This is especially true when the ratio of workers to pensioners is projected to decline dramatically in the future, as is the case.

- Because financial markets are increasingly integrated globally, much of an increased retirement savings flow in Canada will find its way into the global financial markets. Because these global markets offer the best opportunities to diversify longer term risks, the globalization of Canadian retirement savings should be seen as a positive, not a negative, development for the 'financial wellness' of Canadians.

- Despite this globalization process, local investors will continue to have a 'home country bias'. Thus a significant portion of an increased retirement savings flow will be invested in Canada, with a special focus on investment opportunities where local investors have an informational advantage.

- The made-in-Canada 'virtuous circle' we describe would not go unnoticed by foreign investors. The developments set out above would make Canada a highly desirable place to invest, inducing capital inflows, and thus reducing our cost of capital relative to the rest of the world.

So where does this leave us? The philosopher Pascal explained why he chose to believe in God this way: "If there is a God, I will lead a virtuous life and at the end be lifted to the heavens. If there is no God, what is lost by leading a virtuous life?" Similarly we might say that a broadly-based, rising Canadian retirement savings stream has the potential to do much economic good, but even if that potential is not fully realized, where is the harm in fostering a culture of self reliance and paying one's own way?

How Investment Returns and Fees Impact Retirement Income

The long term impact of compounding investment returns has been described as one of the wonders of the world. Table I demonstrates why this is so in the context of generating pension income. Note that under the assumptions set out, the earnings replacement rate (ie., the pension payable as a proportion of final earnings) falls dramatically for each 2% decrement in investment return on retirement savings over the 35 year period. In fact, each decrease in the pension payable per 2% return decrement is a proportionately equal 40% drop. This demonstrates a commonly used rule of thumb in pension finance: a 1% decrement in long term investment return leads to a 20% decline in retirement income.

Table I Estimated Final Earnings Replacement Percentages under Four Investment Return Assumptions

Earnings Replacement	**83%**	**50%**	**30%**	**18%**
Investment Return	10%	8%	6%	4%
Other Key Assumptions	• Entry age is 30, retirement age is 65. • Contribution rate is 10% of salary. • Salary growth averages 6%. • A single life, level pay annuity with a 10-year guarantee.			

A related rule in pension finance is that only net returns compound, not gross returns. In other words, if a pension fund or an RRSP earns 8% but has to pay out 2% of assets in expenses, the net fund return is only 6%. Table I translates the impact of those expenses into the lost pension payable: a 40% reduction! Alternatively, it will take a 66% higher contribution rate to maintain the original target pension.

In recent years, the extraordinarily high capital market returns have caused many investors to lose track of this negative compounding effect of high investment costs. Future retirement savings returns are now realistically in the 6% to 8% range before expenses. In such an investment environment, high fees would have a devastating impact on the ability of Canadians to generate adequate retirement income streams at affordable contribution rates. Conversely, low fees are an essential element in converting affordable contribution rates into adequate retirement income streams.

Pension Fund Governance

Because net investment returns have such a major impact on the adequacy and cost of future retirement income streams, how well or poorly investment funds are managed matters a great deal. Recent research confirms that the two most critical ingredients in the management of pension funds are fund size, and the quality of their governance and management processes. On average, larger pension funds with highly rated governance/management processes have had significantly better investment results (eg., 1% per annum higher risk adjusted net returns or

better) than smaller funds with poorly rated processes [19]. Using the rule of thumb developed above, this means large, well governed and managed pension funds will deliver 20% higher pensions for a given contribution rate than small, weakly governed and managed pension funds.

In explaining these findings, the research noted that larger pension funds can take advantage of significant economies of scale to reduce unit operating costs. Also, they have the ability to hire a qualified pension fund executive to whom the fund's governing fiduciaries can delegate the creation and implementation of a strategic plan for the pension fund. These steps lead to clarity about the organization's mission and vision. They also lead to clarity about organization design, the delegation of responsibilities, and about how results are to be measured. Smaller funds, on the other hand, tended to have significantly higher unit operating costs, and tended to have incomplete, part time governance and management structures. As a result, many of the organizational characteristics associated with good governance and management tend to be missing. This in turn produced, on average, relatively poor investment results.

In economic terms, we are dealing with a phenomenon called 'informational asymmetry'. Specifically, the providers of financial services such as portfolio management are specialists with a great deal of knowledge about financial markets and how they work. In contrast, pension plan members and sponsors generally only have limited knowledge. This 'asymmetry' gives the services providers a material potential advantage in contracting with the buyers of their services. It is only when the buyers are represented by a sophisticated pension fund organization that the informational playing field is leveled, or even tipped in favor of the pension plan stakeholders. Only in these latter cases can stakeholders reasonably expect to receive full 'value for dollars'.

These research findings support the recommendations of the previously cited Senate Committee report on institutional funds governance and management [20]. Specifically, the Committee recommended that ACPM work together with the Pension Investment Association of Canada (PIAC) and the federal Office of the Superintendent of Financial Institutions (OSFI) to develop a common set of governance guidelines for pension fund fiduciaries. The Committee also asked for the development of a 'best practices' framework which would permit governing fiduciaries to assess the quality of their own governance process.

We are pleased to report that these three organizations, joined by Ontario's FSCO, are working together to implement the Senate Committee's recommendations regarding pension fund governance.

Investment Fund Governance

We believe that the findings of the pension fund research study cited above are directly relevant in an investment fund context. Indeed, for obvious reasons, the 'informational asymmetry' problem we cited above is even more prevalent and severe at the retail level. As a result, for example, where most pension funds incur annual operating costs (expressed as % of assets) in the 0.1% to 0.5% range, many investment fund investors pay annual fees in excess of 2%. Canadian investment fund investors currently do not benefit from boards of governing fiduciaries legally charged with looking after their financial interests.

Thus we also concur with the recommendation of the cited Senate Committee report regarding investment fund governance. Specifically, investment funds should also be governed by fiduciaries (eg., a board of directors), the majority of which are independent of the fund advisor. These fiduciaries should represent the interests of the investment fund shareholders in their dealings with the fund advisor. We noted that Glorianne Stromberg had already reached these conclusions in her 1995 and 1998 studies. We also note that mutual funds in the USA have had their own boards of directors for almost 60 years now. The SEC has recently re-affirmed the value of this governance function, and is taking steps to strengthen it.

In Canada, the Senate Committee and the Stromberg Reports both recognize that the establishment of an independent governance function will require the enactment of legislation that would recognize a business trust structure that would be similar to a corporate structure. It would include provisions for directors and officers of the trust, the extent of their independence, how they may be elected and removed, how fundamental changes in the trust would be made, and share or unit holders' rights and remedies. It will be interesting to see what Stephen Ehrlichman's study commissioned by the OSC has to say on this topic. It is due December 1999. Beyond whatever legislation eventually results, investment fund directors will have to establish codes of 'best practices'. Fortunately, they will be able to look to such codes already established in the pension fund sector for guidance [21].

We close by noting that progressive Canadian investment fund organizations will not want to wait until legislation forces them to create independent governance structures for their investment fund families. They will see such a step to be in the best interests of their investment fund share or unit holders, and start the process now.

Investment Fund Governance and Corporate Governance

We believe that better pension and investment fund governance in Canada will ultimately improve Canadian corporate governance as well. Why? Good investment fund governance will align the interests of fund stakeholders and the providers of portfolio management services. This in turn will reduce the amount of adversarial trading (ie., trading to improve the performance of one investment manager at the expense of another) between pension and investment funds as such trading is expensive, and in an arena where it is exceedingly difficult for any single portfolio manager to maintain an informational advantage over the competition, ultimately futile most of the time [22].

With the increased recognition of this reality through good pension and investment fund governance, the question arises whether there are other, more effective ways to improve fund performance. One such way is for the managers of pension and investment funds to increasingly hold the directors of the corporations in which they have invested accountable for creating long term shareholder value. Increased pressure for long term corporate performance from visible, knowledgeable institutional investors will not go unnoticed or unrewarded. It is noteworthy that the International Corporate Governance Network, founded only in 1995 by a consortium of major institutional investors, has quickly become an important new voice in the corporate governance arena [23].

The Regulation of Pension Plans

We have already noted that the current patchwork quilt of federal and provincial schemes to regulate registered pension plans in Canada is frustrating, inefficient, and expensive. The regulations are complex and sometimes conflicting. ACPM believes the answer to this serious problem lies in a single Uniform Pension Act adopted in the federal and all provincial jurisdictions. ACPM has taken the initiative to draft a Uniform Pensions Act, and is currently in the process of receiving comments from all stakeholders who would be affected.

We urge stakeholders to work together to bring this important initiative to a successful conclusion. This will involve compromises of positions. One key step would be for the Ministers responsible for pensions across Canada, who have never formally met to discuss pension issues, to meet and discuss the role of pension legislation from a national and long term perspective. We urge the Canadian Association of Pension Supervisory Authorities (CAPSA) to continue to work among themselves and to impress upon their respective Ministers the need for uniformity. We urge employers to look beyond the immediate cost of raising some minimum standards, and members to work with ACPM to find solutions to problematic issues.

To take no comprehensive action in respect of uniformity, or to take only small steps, will result in further fragmentation of pension legislation in Canada. On the other hand, substantive uniformity would go far to encourage employer-sponsored pension plans, thus strengthening the third pillar of our retirement income system. This can only be to the advantage of working Canadians, and to the advantage of governments rightly concerned about the future costs of an aging population.

The current rules governing post retirement income arrangements such as LIFs and RRIFs are just one example of the current legislative/regulatory complexity facing Canadian employers. Some would like to be able to administer these arrangements through their own pension plans in order to serve their members better at reduced costs to those members. However, there are considerable obstacles to doing so embedded in both provincial pension regulations and Revenue Canada rules. Without uniformity, removing these obstacles will be a complex, slow, expensive undertaking.

The Regulation of Investment Funds

The Canadian Securities Administrators (CSA) have expressed the view that Canada must move to a regime of functional regulation, which categorizes regulatory needs as being either primarily prudential or market-oriented in nature. The CSA has also suggested that such organizations as OSFI and FSCO should look after prudential regulation, while the CSA focuses on market-oriented regulation [24]. This raises the critically important question of where investment fund regulation fits into this new regulatory framework.

The current reality is that investment funds are effectively financial products designed, branded, and sold by financial services complexes to retail consumers. Thus in the CSA's functional framework, the primary regulatory responsibility for mutual fund products (eg., how they are produced, labeled, sold, etc.) would currently lie with Canada's securities regulators, and whatever self-regulatory organizations (SROs) they choose to delegate responsibilities to. We have already questioned whether this 'product' approach to investment funds and its regulatory implications will best serve the long term financial interests of Canadians.

Instead, we believe that the long term financial interests of Canadians would be better served if investment funds are effectively defined and treated as trust funds governed by independent fiduciaries. These fiduciaries would be required by law to look after the financial interests of the unit holders. Such a view has important regulatory implications. In a functional context, the primary regulatory responsibility now shifts to the prudential regulators. The primary question now becomes whether investment fund fiduciaries are faithfully discharging their responsibilities to unit holders using 'best practice' procedures.

Of course, it is not quite that simple. As Glorianne Stromberg has pointed out in her reports, even in a world where investment funds were governed by independent fiduciaries, there are still remaining questions about the sales practices of investment fund dealers, about disclosure, about uniform competence standards for financial planners, and so on. Thus, even if investment funds implemented new governance structures, there will still be plenty for Canada's securities regulators to do.

We close our discussion on investment fund governance with what should now be an obvious conclusion. Investment fund regulation (or lack of it) is at an important crossroads in this country. It is impossible to settle on the best regulatory model without deciding on the right governance model first. Adopting the independent fiduciary governance model for Canadian investment funds must be our first order of business.

Removing The 20% Foreign Property Rule

The 1997 ACPM paper listed a number of reasons why the 20% FPR was an extremely harmful piece of legislation which, ironically, benefited no-one. Since then, the list of studies and organizations condemning the FPR has grown considerably, including some within the federal government itself. ACPM is extremely disappointed by the inaction of the federal government to strike this rule from the Income Tax Act.

Once again, we are compelled to point out that extensive research suggests that the FPR:

- Prevents many Canadian investors from properly diversifying their retirement assets, and forces them to take on unnecessary and uncompensated risks.

- Reduces future tax revenues by slowing the build-up of retirement savings taxable as future retirement income.

- Creates unnecessary measurement and implementation costs, as well as risks, as investors try to modify its negative impact. The recent introduction of ‘clone funds’ which permit the investment in foreign funds without breaching the FPR though a complicated intermediation structure at a higher cost is a perfect example of this problem.

- Signals to the world that Canada is not secure enough financially to permit its own investors to invest their retirement savings as they see fit. This raises Canada’s cost of capital.

- Does nothing to lower the cost of capital in Canada.

- Does nothing to increase the supply of risk capital in Canada.

- Does nothing to increase employment in Canada.

- Engenders cynicism about the intentions of Canadian politicians with regard to the accumulated retirement savings of Canadians.

We have come to the view that the positive signaling effect which would attach to the immediate, complete withdrawal of the 20% FPR would likely more than offset any other possible impacts. In other words, we have reached the point where the complete elimination of the rule from the Income Tax Act in the next Budget would have a positive impact on our financial markets and our currency, not a negative one.

SECTION VII MAKING OUR RETIREMENT SYSTEM WORK IN THE 21ST CENTURY: WHAT WE NEED TO DO

This section follows naturally from Sections V and VI. It lists the steps we need to take now to create a retirement system which will serve us well in the 21st century. The steps are organized into 'to do' lists for the people who need to take them.

What Canadians 'At Large' Must Do

We believe that the major changes Canada needs to make to its retirement income system will only come about if a majority of Canadians come to believe they should be made. Thus to them we say:

- Become familiar with the issues discussed in this report, and how they may impact you and your families.
- Decide on the degree to which your personal 'financial wellness' plan should be based on self-reliance rather than on the ability and willingness of future tax payers to provide Pillar #1 pensions during a period of falling worker-per-pensioner ratios.
- Decide on what kind of income replacement rate makes sense for you in the future. Would you prefer to drop out of the workforce completely at a given point, or gradually ease out over a number of years?
- If Canada's current social policy and tax arrangements are at odds with the implementation of your 'financial wellness' plan, are you willing to make your views known to your employer? Your provincial MPP/MLA? Your federal MP? Are you willing to speak out?

What Canadian Employers And Unions Must Do

Canadian employers and unions in the private and public sectors have the resources at their disposal to reduce what we called 'informational asymmetry' in Section V. To them we say:

- Become familiar with the issues discussed in this report, and how they will impact on your workforce, your membership, your shareholders -- or in the public sector, the tax payer.
- Assess the degree to which your current retirement income arrangements are truly 'win-win' between the employer and plan members, and reflect current economic and workplace realities. Employers and organized labour would do well to co-operate in this quest rather than jealously guard their respective turfs.
- Assess the degree to which your current retirement income system should be redesigned to encourage later, rather than early retirement.

- If Canada's current social policy and tax arrangements are at odds with the design of what you believe to be the best possible retirement income system design for the 21st century, what are you prepared to do to bring about the necessary changes?

What The Federal Government Must Do

Resolute leadership by the federal government on the issues we discuss in the report would be the most direct route to making the social policy and tax system changes necessary to create a fair, sustainable, efficient 21st century retirement income system. However, because many of the issues we discuss need to be seen in a 20(+) year context to fully understand their importance, the reality of a four year political election cycle is a serious obstacle. It will be a real test of government mettle to take the following steps:

- Acknowledge publicly that the CPP/QPP reform steps already taken only begin to address the major economic and moral challenges Canadians will face as its workers-to-pensioners ratio begins to fall significantly, starting only a decade hence. Commit to providing regular (eg., 3 year) objective assessments of the long term sustainability of Canada's retirement income and healthcare systems.

- Acknowledge publicly that its '50-50' spend-lower taxes/debt rule to allocating current budget surpluses without having made a careful assessment (publicly shared with Canadians) of the long term sustainability of Canada's retirement income and healthcare systems is putting the cart before the horse.

- Play a leading role in sketching out the implications of the challenges facing our retirement income system, and creating processes through which Canadians can come to grips with the difficult choices which they face. In Section V we sketched out some of the conclusions we believe such a process would lead to:

    1. A much greater immediate emphasis on reducing the public debt than is currently the case.

    2. Restraining the future availability of Pillar #1 public pensions as much as possible, with a needs assessment based on broader means tests (ie., exploring the extent to which assets should be considered) using the new Market Basket Poverty Measures as the reference point, and allowing for the different needs of singles and couples.

    3. Measures to encourage and facilitate longer working lives for Canadians. For example, the CPP/QPP currently offers options which act as early retirement incentives. These will need to be redesigned so that they motivate workers to retire later rather than earlier. Similarly, the Income Tax Act should be reviewed with an eye to providing incentives for later, rather than early retirement.

4. Reducing current disincentives for middle income Canadians to save for their own retirement. The combined effect of taxes and OAS/GIS clawbacks should in no case produce an effective marginal rate of more than 50%.

5. A doubling of the tax-deferred contribution room available to build up voluntary Pillar #3 arrangements through employer and union-based pension plans and regular individual and group RRSPs.

- Meanwhile, the federal government should take the following immediate steps:

1. Pledge to create equivalence between the levels where seniors receive means-tested minimum public pensions and where working people begin to pay taxes.

2. Begin to raise the long-frozen contribution ceilings on pension plans and RRSPs. For example, a 20% increase in the next Budget would be a good start.

3. Modify the pension adjustment rules to reflect the fact that many corporate defined benefit pension plans provide less generous ancillary benefits than public plans. This could be accomplished by reducing the adjustment factor from 9 to 7 for those plans.

4. Equalize opportunities for pension income splitting between spouses under RRSPs and employment-based pension plans.

5. Permit registered pension plans to administer LIFs and RRIFs.

6. Better inform Canadians about their retirement income system by encouraging Statistics Canada to provide a balanced information flow about such issues as individual and group RRSP participation rates, seniors poverty rates, pension coverage by labour market segment, and growth of assets. Also, the federal government should share its new research findings on the controversial 'tax expenditures' question related to pension plan and RRSP contribution ceilings.

7. Eliminate the 20% Foreign Property Rule from the Income Tax Act.

8. Formally endorse the Senate Committee on Banking, Trade, and Commerce recommendations regarding pension fund, and especially investment fund governance. Work with the provinces to discover how best to enact legislation which would lead to investment funds being governed by boards of directors required to act in the best interests of unit holders.

9. Encourage OSFI and Revenue Canada to work with ACPM and provincial regulators to help create a single, sensible Uniform Pension Act which would apply to all registered pension plans in Canada, and to work with provincial regulators to sort out the remaining regulatory issues surrounding financial planning and the distribution of investment funds.

What Provincial Governments Must Do

Provincial governments are responsible for two areas of importance to a well-functioning retirement income system: education and regulation. We recommend that all provincial governments:

- Instruct their ministries of education to design (with significant input from experts) and require the teaching of 'financial wellness' courses at the primary and secondary education levels.

- Encourage their pension regulators to work with ACPM to create a single Uniform Pension Act which, when enacted federally and provincially, would apply to all registered pension plans in Canada.

- Encourage their securities regulators to take a leadership role in sorting out the many unresolved issues in the field of investment fund regulation. We noted in Section VI that the first order of business must be to resolve how investment funds are to be governed.

What The Financial Services Industry Must Do

Canada's financial services industry can also play an important role in making our retirement income system work better:

- Devise effective education programs to help their clients build informed 'financial wellness' plans.

- Offer Canadians transparent, low cost, easily accessible investment vehicles with which they can reliably meet their long term 'financial wellness' goals.

- Take the lead in creating investment fund boards of directors charged with looking after the financial interests of unit holders.

The Best Retirement Income System In The World

The 1997 ACPM Paper concluded with these words: "If we all pull together, creating the best retirement income system in the world lies within our grasp". We hope that this updated 2000 paper will help jump-start the process. Time is getting short.

SECTION VIII END NOTES

[1] "Averting the Old Age Crisis", a World Bank Policy Research Report, Washington D.C., 1994.

[2] For further discussion and debate on the measurement of poverty, see Michael Wolfson and John Evans, "Statistics Canada's Low Income Cut-Offs: Methodological Concerns and Possibilities", A Discussion Paper, Statistics Canada, Ottawa, 1990; "Poverty in Canada", Christopher Sarlo, Fraser Institute, Vancouver, 1992; Monica Townson, Canada National Advisory Council on Aging, Ottawa, 1994.

[3] David Slater has been writing on "tax expenditure" issues from a Canadian perspective for some years now, most recently in his draft paper "Tax Relieved Retirement Savings Programs: Measurement of Benefits and Costs", June 1999. He is currently revising this paper, and expects to have a final version out in early 2000. He can be reached at david.slater@sympatico.ca.

[4] Peter G. Peterson, "Gray Dawn", Times Books, Random House, New York, 1999.

[5] Dian Cohen, "The New Retirement", Doubleday, Canada, 1999.

[6] For more information on the C.D. Howe Institute and its series of publications on Canada's retirement income system, visit its web site http://www.cdhowe.org.

[7] Keith Ambachtsheer, Don Ezra, "Pension Fund Excellence", John Wiley & Sons, New York, 1998; and Mary DiSpalatro, "The New Imperative", MacLean Hunter Financial Media, Toronto, 1998.

[8] Glorianne Stromberg, "Regulatory Strategies for the Mid-'90's", Ontario Securities Commission, Toronto, January 1995, and "Investment Funds in Canada and Consumer Protection", Industry Canada, Ottawa, October 1998.

[9] "The Governance Practices of Institutional Investors", Standing Senate Committee on Banking, Trade, and Commerce, Ottawa, November 1998.

[10] Keith Ambachtsheer, Ronald Capelle, Tom Scheibelhut, "Improving Pension Fund Performance", Financial Analysts Journal, November-December 1998.

[11] "A Framework for Market Regulation in Canada", The Canadian Securities Adminstrators, February, 1999.

[12] Jason Clemens, Fazil Mihlar, "The 20% Foreign Property Rule", Fraser Institute, Vancouver, Spring 1999; Joel Fried, Ron Wirick, "Assessing the Foreign Property Rule: Regulation Without Reason", C.D. Howe Institute, Toronto, December 1999.

[13] An exception is the Career and Life Management Course for Grade 11 students in Nova Scotia.

[14] Many of the statistics in this section come from Pete Peterson's "Gray Dawn", which in turn makes liberal use of OECD studies. The definition of the relevant 'dependency ratio' raises an interesting point. In some Canadian studies we have seen, the ratio is based on pensioners relative to the working age population. This ratio is projected to go from 1:5 now, to 1:2.5 in 2030. In this paper we use the ratio of pensioners to people actually working, and hence paying taxes. This more relevant ratio is projected to go from 1:4 to 1:2. In the text, we actually cite the reverse of this ratio. The paper notes that the workers to pensioners ratio is projected to fall from 4:1 now, to 2:1 in 2030.

[15] See David Slater, William Robson, "Building a Stronger Pillar: The Changing Shape of the Canada Pension Plan", C.D. Howe Institute, Toronto, March 1999. The authors argue that some of the assumptions which produce the 'steady state' 9.9% contribution rate are "problematic".

[16] See "Gray Dawn", page 69.

[17] ACPM's 1997 Paper, "A Retirement Income Strategy for Canada", recommended that "Pension adjustment rules should be modified to reflect differences in indexing provisions of employer-sponsored pension plans. Specifically, the current 'factor of 9' should be adjusted to a 'factor of 7' for plans which provide for indexing of benefits at a rate which is less than 50% of the increases in the CPI". The paper also recommended that "opportunities for pension income splitting between spouses under RRSPs and pension plans should be equalized". See page 32 of the Paper for elaborations on both recommendations.

[18] See, for example, Malcolm Hamilton, "The Retirement Myth", Money Sense, June-July 1999, and "How's Your Safety Net?", The Wealthy Boomer, Fall 1999.

[19] From the "Improving Pension Fund Performance" study cited in Note [10] above.

[20] See Note [9] above.

[21] These 'best practices' are described in works cited in Notes [7] and [10] above.

[22] This observation is supported by a large body of research which suggests that, on average, actively managed funds underperform index funds by at least the higher fees the active funds charge. Further, there is little evidence to suggest that active funds which perform relatively well in one period will repeat that feat in the next period.

[23] See an article by Michelle Tan "The Global Governance Working Kit", Corporate Governance Review, Fairvest Securities Corporation, Toronto, June-July 1999.

[24] See the paper cited in Note [11].